VZCZCXRO5710
PP RUEHCN RUEHGH RUEHVC
DE RUEHHK #4265/01 3050037
ZNR UUUUU ZZH
P 010037Z NOV 06
FM AMCONSUL HONG KONG
TO RUEHC/SECSTATE WASHDC PRIORITY 9253
RUEATRS/DEPT OF TREASURY WASHDC PRIORITY
INFO RUEHOO/CHINA POSTS COLLECTIVE

UNCLAS SECTION 01 OF 03 HONG KONG 004265

SIPDIS

SENSITIVE
SIPDIS

STATE FOR EAP/CM
BEIJING FOR DLOEVINGER, PCHOW, KHARPER
TREASURY FOR DOHNER/HAARSAGER/BAKER/CUSHMAN

E.O. 12958: N/A
TAGS: EFIN ETRD HK CH

SUBJECT: HK Economists discuss China's Economy, Banking in China, and the Strategic Economic Dialogue

## Summary

¶1. (SBU) Summary: Hong Kong economists, bankers, and Hong Kong Monetary Authority (HKMA) officials told Embassy Beijing Minister-Counselor for Financial Affairs David Loevinger (Finatt) that the rate of renminbi (RMB) appreciation would not sustain the rate it achieved following the September visit of Treasury Secretary Paulson and the withdrawal of the Graham-Schumer Bill, but would remain at a modest 3-5 percent a year. Given a steady, moderate appreciation, most of the economists thought China's external competitiveness would continue to improve, with a large current account surplus and speculative inflows. The People's Bank of China (PBOC) thus will continue its large-scale sterilized intervention for the foreseeable future. Chinese authorities should tighten monetary conditions further (through both interest rate hikes and a more liberalized exchange rate) said the economists, though they noted the political constraints caused by urban/rural income gaps. Foreign bankers reaffirmed that the China Banking Regulatory Commission's (CBRC) requirement for foreign banks to incorporate in order to provide RMB denominated services would not be a major barrier to entry. On the Strategic Economic Dialogue, one economist thought Vice Premier Wu Yi was an "interesting choice" to head the Chinese side as she has no responsibilities for financial or macroeconomic issues. End Summary.

## RMB Valuation, Trade Imbalances

¶2. (SBU) Embassy Beijing Minister-Counselor for Financial Affairs David Loevinger, Economic Officers Patrick Chow and Byron Tsao, and Economic Specialist Kevin Harper met with Hong Kong-based China economists, investment bank representatives, and Hong Kong Monetary Authority (HKMA) officials on October 5-6 to discuss China's economy, financial sector, and the U.S.-China Strategic Economic Dialogue (SED).

¶3. (SBU) Deutsche Bank economist Jun Ma thought that although China is grateful to Treasury Secretary Paulson for his role in the withdrawal of the Graham-Schumer legislation, China feels it has now "given enough face" to Paulson and is unlikely to let the RMB appreciate beyond a modest 3-4 percent per year. As a result, given continued substantial differences in labor productivity growth between China and the U.S. (7-8 percent for China versus 2-3 percent for the U.S.), maintaining such a modest rate of RMB appreciation means that export competitiveness will continue rise. As a result, Ma predicted that Chinese export growth will continue to outpace GDP growth, leading to rising external imbalances. Another factor limiting the Chinese Government's willingness to allow for greater RMB appreciation is the need to protect unskilled workers, who are not experiencing significant productivity gains, particularly

vis-`-vis increasingly competitive and cheaper labor in Southeast Asia. The key to reducing the current account surplus, which is 7% of GDP, concluded Ma, is to increase import growth by cutting Chinese import tariffs beyond World Trade Organization (WTO) commitments.

¶4. (SBU) Bank of International Settlements Senior Economist Ma Guonan said he believed that the People's Bank of China (PBOC) is holding back RMB appreciation until after the Industrial and Commercial Bank of China's (ICBC) IPO. ICBC, like the other large state banks, maintains a long dollar position to enhance its balance sheet. Ma predicted that the current account surplus would shrink noticeably next year once people finish repositioning their portfolios in anticipation of a stronger RMB. Ma then argued that the current account surplus may not be as large as it appears because capital inflows, which account for an important part of the surplus, are taking place through both over and under-invoicing of current transactions. Furthermore, large and growing amounts of personal remittances should actually be accounted for as investments and not gifts. Multinational corporations also appear to be hoarding RMB as the growth of the stock of foreign direct investment (FDI) continues to outpace the growth of profit remittances.

¶5. (SBU) Julia Leung, Executive Director, External Department of the Hong Kong Monetary Authority (HKMA), told Finatt that PBOC Governor Zhou's comments in the Chinese finance magazine "Caijing" were an important signal that the PBOC would soon allow for greater RMB volatility. In the article, Zhou comments that the RMB would be based "more on supply and demand," also signaled greater RMB appreciation.

¶6. (SBU) Hong Kong University (HKU) Professor Geng Xiao, who will be moving to Beijing to direct a new Qinghua University-Brookings think tank, felt that the RMB should appreciate between 3-4 percent per



year to account for relative productivity differentials, and to appreciate by even more by the extent to which U.S. inflation exceeds Chinese inflation. Geng agreed with Jun Ma that the unequal distribution of labor productivity growth means that rapid RMB appreciation would hurt unskilled workers, which the government politically must protect. Geng urged the U.S. to press for greater liberalization of China's service sector. This would increase productivity and lower the price of services in China, thus freeing money that could spur an increase in imports. Unfortunately, he concluded, Chinese ministries tend to focus on the health of firms in the sectors they oversee and thus fail to grasp how increased competition in protected sectors can benefit the broader economy.

## Is China Overheating?

¶7. (SBU) Geng Xiao told Finatt that he did not see overheating as a significant risk, as China can "grow through" asset bubbles. He also did not think that overall investment was too high, given still-high returns on public infrastructure investment. However, he did see significant scope to improve the efficiency of investment, particularly by having the National Development and Reform Commission (NDRC) decentralize more decisions on finance to local and provincial governments.

¶8. (SBU) Jun Ma cited three factors accounting for the growth in Chinese monetary aggregates that continue to fuel the growth in investment. In addition to foreign currency intervention due to large balance-of-payment (BOP) surpluses, large PBOC loans to non-bank financial firms, which Ma thought were most likely securities firms, had been an important factor for the increase in base money. Ma thought up to 50 percent of the loans are not likely to be paid back. In addition, an increase in the money multiplier was causing the growth of broad money (M2) to exceed the growth of base money, which increased Chinese banks' loanable resources despite PBOC's sterilization efforts. Ma continued that this increase was driven by improvements in Chinese payment systems that reduced the time needed to settle payments, thus reducing the need to hold large excess reserves with the central bank.

¶9. (SBU) Ma expressed concern over the lack of cooperation between the Ministry of Finance (MOF) and PBOC. The MOF tends to set the term structure of its Treasury bills and bonds mainly to minimize its cost of financing. As a result, it issues insufficient short-term treasury bills, forcing the PBOC to issue its own short-term bonds for sterilization. The PBOC is increasingly concerned that the interest cost of sterilization bonds will lead to net income losses and ultimately even the possibility of insolvency. Ma continued that the strength of PBOC's balance sheet in RMB terms is exaggerated as it does not mark to market its foreign exchange reserves, but rather values its foreign securities at the cost incurred at the time of purchase, including the exchange rate prevailing at that time. [Comment: Despite statements by PBOC officials, including from Governor Zhou to Al Hubbard on September 21, that PBOC can comfortably sterilize foreign exchange intervention for several more years, other analysts have noted that fiscal concerns may be limiting the extent to which the PBOC is willing to sterilize such interventions.]

## New Opportunities in Chinese Finance

¶10. (SBU) Several economists and financial company officials commented on recent moves by their firms to enter the Chinese financial services market. Standard Chartered Economist Tai Hui said that one reason Standard Chartered established Bohai Bank as a greenfield investment, despite their plans to expand Standard Chartered branches in China, is that they expected that banks classified as domestic institutions would still receive more favorable regulatory treatment even after the implementation of China's WTO commitments.

¶11. (SBU) Morgan Stanley Managing Director and COO Asia Greg Terry told Finatt that contrary to press reports, their recent acquisition of Nantong Bank from Bank of China Macau did not gain them a lead over other foreign banks in obtaining a license to provide RMB denominated services. Nantong currently has licenses to provide foreign exchange denominated services to retail and corporate clients. Morgan Stanley has no interest in retail RMB business; they are seeking licenses to provide RMB services to corporate clients and to offer derivatives. Neither the PBOC nor the CBRC have suggested they incorporate to conduct RMB business, but Morgan Stanley will do so if necessary, given that they do not view the minimum capital requirements as overly onerous.



¶12. (SBU) Terry told Loevinger that CSRC Chairman Shang Fulin's political ambitions are currently an obstacle to the opening of the securities sector. The Chinese government has allowed three foreign firms into the securities sector. Terry said only the UBS/Beijing Securities model is viable; Goldman Sach's arrangement, which involved an unsecured loan to the major Chinese shareholder, is not replicable. Morgan Stanley's stake in CICC is purely passive; it plays no role in running the business. He also voiced his appreciation for Treasury's efforts to engage CSRC on this issue.

¶13. (SBU) Commenting on UBS' recent acquisition of Beijing Securities, UBS Chairman and CEO for Asia Pacific Rory Tapner told Finatt that Beijing Securities will be renamed UBS Securities (China)and will have a comprehensive license to trade, distribute, and underwrite A shares. For UBS, the ability to trade A shares is key, as it is critical to their ability to distribute underwritten shares to customers. UBS was nicely surprised to discover that Beijing Securities had licenses to engage in wealth management, which no other foreign banks have. Tapner said finding employment for Beijing Securities staff was an important, and politically sensitive, issue. UBS will keep six of Beijing Securities' 27 branches, selling 21 to China Merchants Bank. They will also retain 180 of Beijing Securities' 600 employees, with 400 moving to China Merchants Bank. As in the other two securities sector deals involving foreign investment banks (Morgan Stanley/CICC and Goldman Sachs/Gao Hua), current Beijing Mayor Wang Qishan played a prominent and critical role.

¶14. (SBU) On other mainland financial issues, HKMA's Leung said the

Chinese government's upcoming high-level financial meeting would most likely take place in late October. One issue that might be discussed is the extent of FDI in the financial sector, and in particular, a review of allowable FDI in Chinese banks. Leung discussed ASEAN+3 efforts to promote China's bond markets. To create an exchange traded China bond index fund as part of the second Asian Bond Fund (ABF2), it will be necessary to shift some of the underlying bonds from the inter-bank bond market, regulated by the PBOC, to the stock market, regulated by the CSRC. This will spur greater cooperation among the regulators.

SED: Why Wu Yi??
----------------

¶15. (SBU) Jun Ma questioned China's choice of Vice-Premier Wu Yi to head the recently announced U.S./China Strategic Economic Dialogue. Ma noted that although Wu Yi covers trade issues, she has no financial portfolio and is thus an "interesting" choice to head the Chinese side of the dialogue. Any discussion of financial matters would have to be passed to Premier Wen Jiabao.

¶16. (SBU) HKMA's Julia Leung, commenting on Wu Yi as China's counterpart for Secretary Paulson for the SED, noted however, that Wu Yi "can deliver." During Hong Kong's interaction with Vice Premier Wu Yi during the Closer Economic Partnership Agreement (CEPA), Wu shepherded various Chinese ministries to reach agreement.

¶17. (U) Embassy Beijing Minister-Counselor for Financial Affairs David Loevinger cleared this report.